



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Date: June 25, 2013

Number: **201338043**
Release Date: 9/20/2013

UIL: 501.02-03

Contact Person:

Identification Number:

Contact Number:

FAX Number:

Employer Identification Number:

Legend

Son =
Father =
Corporation =
ESOP =

Dear :

This is in response to your letter dated July 24, 2012, submitted by your authorized representative, requesting rulings under I.R.C. § 4943.

Facts

You have been recognized as exempt from federal income taxation under § 501(c)(3) and classified as a private foundation under § 509(a)(1). Your primary activity is making grants to various health, human services, and education organizations that are also exempt from taxation under § 501(c)(3). Your founder and major contributor is Father, who passed away in 2011. Your board president and director is Son, Father's son.

Father was also a founder of Corporation, a privately held corporation. Corporation has nine directors. No familial or outside business relationships exist between any of these directors.

One of Corporation's directors is Son. Two other directors of Corporation are also on your board. In total, three of the nine members of Corporation's board of directors are also on your board.

At the time of Father's death, all of the stock that he owned in Corporation was held in a revocable trust. Following his passing, portions of the stock owned by Father were distributed to you, to Son, and to a trust the beneficiaries of which are Son and his two children. You have represented that the combined shares of stock in Corporation owned by you, Son, and the trust add to just below 35 percent of the total corporate stock.

You represent that the remaining stock in Corporation is owned by non-disqualified persons as defined in § 4946. All stock that has been issued by Corporation is voting, and over percent

of the total stock is owned by an employee stock ownership plan, ESOP, established by Corporation for the benefit of its employees. The other shares of stock are owned by individuals with no connection to you.

ESOP, the majority shareholder in the Corporation, is set up such that its assets are owned by a trust and it votes its shares of stock through a trustee. A committee, consisting of three individuals, directs the trustee as to how to vote the interests of trust. The committee's directives to the trustee are decided by a majority vote, of two of its three members. The three members are appointed by Corporation's board of directors. The committee's present members are Son and two individuals with no affiliation to you, or your disqualified persons. Each committee member was duly appointed by Corporation's board of directors.

Rulings Requested

You requested the following rulings:

1. That effective control of Corporation is in one or more persons who are not disqualified persons with respect to you within the meaning of § 4943(c)(2)(B).
2. That your permitted holdings in Corporation are 35 percent of the voting stock reduced by the percentage of the voting stock owned by your disqualified persons.

Law

I.R.C. § 507(d)(2) defines the term "substantial contributor" as any person who contributed an aggregate amount of more than \$5,000 to the foundation, if such amount is more than 2 percent of the total contributions received by the foundation before the close of the taxable year in which the contribution is received.

I.R.C. § 4943 imposes a tax on the, "on the excess business holdings of any private foundation in a business enterprise."

I.R.C. § 4943(c)(1) defines excess business holdings as, "the amount of stock or other interest in the enterprise which the foundation would have to dispose of to a person other than a disqualified person in order for the remaining holdings of the foundation in such enterprise to be permitted holdings."

I.R.C. § 4943(c)(2)(A) provides, in general, that the permitted holdings of any private foundation in an incorporated business enterprise are -- (i) 20 percent of the voting stock, reduced by (ii) the percentage of voting stock owned by all disqualified persons.

I.R.C. § 4943(c)(2)(B) provides, in general, that if (i) the private foundation and all disqualified persons together do not own more than 35 percent of the voting stock of an incorporated business enterprise, and (ii) it is established to the satisfaction of the Secretary that effective control of the corporation is in one or more persons who are not disqualified persons with respect to the foundation, then § 4943(c)(2)(A) shall be applied by substituting 35 percent for 20

percent.

I.R.C. § 4946(a)(1) provides, in part, that the term 'disqualified person' means, with respect to a private foundation, a person who is-

(A) a substantial contributor to the foundation,

(B) a foundation manager,

(C) an owner of more than 20 percent of –

(i) the total combined voting power of a corporation,

(ii) the profits interest of a partnership, or

(iii) the beneficial interest of a trust or unincorporated enterprise, which is a substantial contributor to the foundation,

(D) a member of the family of any individual described in subparagraph (A), (B), or (C),

(E) a corporation of which persons described in subparagraph (A), (B), (C), or (D) own more than 35 percent of the total combined voting power,

(F) a partnership in which persons described in subparagraph (A), (B), (C), or (D) own more than 35 percent of the profits interest,

(G) a trust or estate in which persons described in subparagraph (A), (B), (C), or (D) hold more than 35 percent of the beneficial interest, and

(H) only for purposes of § 4943, a private foundation –

(i) which is effectively controlled (directly or indirectly) by the same person or persons who control the private foundation in question, or

(ii) substantially all of the contributions to which were made (directly or indirectly) by the same person or persons described in subparagraph (A), (B), or (C), or members of their families, who made (directly or indirectly) substantially all of the contributions to the private foundation in question.

I.R.C. § 4946(b)(1) provides that the term "foundation manager" means, with respect to a private foundation, an officer, director, or trustee of a foundation (or an individual having powers or responsibilities similar to those of officers, directors, or trustees of the foundation).

I.R.C. § 4946(d) provides that for purposes of § 4946(a)(1), the family of any individual shall include his spouse, ancestors, lineal descendants, and spouses of lineal descendants.

Treas. Reg. § 53.4943-3(b)(3)(i) provides that a private foundation's permitted holdings in an incorporated business enterprise may be raised to 35 percent from 20 percent if:

(A) The private foundation and all disqualified persons together do not hold, actually or constructively, more than 35 percent of the voting stock in the business enterprise, and

(B) The foundation establishes to the satisfaction of the Commissioner that effective control (as defined in paragraph (b)(3)(ii) of this section) of the business enterprise is in one or more persons (other than the foundation itself) who are not disqualified persons.

Treas. Reg. § 53.4943-3(b)(3)(ii) defines the term "effective control" for purposes of § 4943 as "the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a business enterprise, whether through the ownership of voting stock, the use of voting trusts, or contractual arrangements, or otherwise." It goes on to say, "It is the reality of control which is decisive and not its form or the means by which it is exercisable. Thus, where a minority interest held by individuals who are not disqualified persons has historically elected the majority of a corporation's directors, effective control is in the hands of those individuals."

Treas. Reg. § 53.4946-1(h) defines member of the family for purposes of § 4946 to include a spouse, ancestors, lineal descendants, spouses of his lineal descendants.

Rev. Rul. 81-111; 1981-1 C.B. 509 considered two situations where a private foundation and its disqualified persons held a combined 35 percent of voting stock in a corporation. In the first situation, the remaining 65 percent of the voting stock was held by a single individual. In the second situation, the remaining 65 percent was held by multiple individuals, who had not entered into any type of agreement concerning their voting rights. In the first situation, the Agency found that effective control was not with disqualified persons. A single non-disqualified person, by virtue of holding a majority of corporate stock, could elect the corporate board. In the second situation, the Agency came to the opposite conclusion. It said that none of the non-disqualified stockholders "alone ha[d] sufficient voting stock holdings in [the corporation] to direct or cause the direction of [its] management and policies..., nor has one of these individuals historically elected the majority of [the] board of directors." It concluded that without any type of voting agreement between the non-disqualified persons, they did not have effective control over the corporation.

Analysis

As a private foundation, under § 4943 you are subject to an excise tax on your excess business holdings. Under § 4943(c)(2)(A), your permitted holdings in Corporation are limited to 20 percent of the voting stock, less the percentage of voting stock owned by all disqualified persons. Under § 4943(c)(2)(B) and § 53.4943-3(b)(3)(i), your permitted levels of voting stock in Corporation may be raised to 35 percent, if you demonstrate that the private foundation and all disqualified persons together do not hold, actually or constructively, more than 35 percent of the voting stock in the business enterprise, and the foundation establishes that effective control of the business enterprise is in one or more persons, other than the foundation itself, who are

not disqualified persons.

First, it is necessary to determine which parties involved with Corporation are disqualified persons with respect to you. Under § 4946 (a)(1)(A) a disqualified person means, with respect to a private foundation, a person who is a substantial contributor to the foundation, a foundation manager, an owner of more than 20 percent of (i) the total combined voting power of a corporation which is a substantial contributor to the foundation; a member of the family of any individual described in above, a corporation in which persons described in above or own more than 35 percent of the total combined voting power. Section 507(d)(2)(A) defines a substantial contributor as any person who contributed or bequeathed an aggregated amount of more than \$5,000 to a private foundation, if such amount is more than two percent of the total contributions and bequests received by the foundation before the close of the taxable year of the foundation in which the contribution or bequest is received by the foundation from such person. Here, Son and all other of your directors and officers are disqualified persons, as they are foundation managers. Son's two children, as the lineal descendants of an officer and director, are also disqualified persons. See Treas. Reg. § 53.4946-1(h). Finally, the trust is a disqualified person because Son and his children themselves are disqualified persons and hold more than 35 percent of the beneficial interest of the trust. See I.R.C. § 4946(a)(1)(G).

You own voting stock in Corporation. Disqualified persons with respect to you, Son and the trust, also own voting stock in Corporation. You have represented that combined, these shares add up to greater than 20 percent but less than 35 percent of the total stock in Corporation. Thus, unless you meet the requirements set forth above for the 35 percent permitted holdings, your ownership of stock in Corporation will subject you to tax for excess business holdings. To determine if your permitted holdings of Corporation's voting stock is 20 percent or 35 percent, it is necessary to examine whether effective control of Corporation for purposes of § 4943 is with non-disqualified persons. Effective control means the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a business enterprise, whether through the ownership of voting stock, the use of voting trusts, or contractual arrangements, or otherwise. It is the reality of control that is decisive and not its form or the means by which it is exercisable. See Treas. Reg. § 53.4943-3(b)(3)(ii). You have represented that the combined ownership of the voting stock of Corporation held by you and all related disqualified persons pursuant to § 4946, either actually or constructively, is less than 35 percent. Therefore, in order to use the 35 percent limitation you must establish that effective control of business enterprise is in one or more persons, other than the foundation itself, who are not disqualified persons.

Like the first situation in Rev. Rul. 81-111, there is a single majority shareholder of Corporation. ESOP holds over 50 percent of Corporation's total voting stock. Its one vote has a greater impact on the management and policies of Corporation than those of you and your disqualified persons combined. ESOP, with just its one vote, has the authority to affect the management and policies of Corporation. It is able with its vote to elect and remove each and every member of the board of directors with or without cause. The question remains whether ESOP is controlled by your disqualified persons, such that they, through their authority over the majority shareholder of Corporation, effectively control Corporation. The vote of ESOP is directed by the vote of a committee. The vote of that committee is determined by the vote of two of its three

members. One member of the committee is a disqualified person; the two others members are not. The arrangement of the committee is unlike the second situation in Rev. Rul. 81-111. There, voting rights were spread out among multiple non-disqualified persons. Here only two non-disqualified persons are involved. The vote of those two non-disqualified persons on the committee would decide the vote of over 50 percent of the voting rights in Corporation and ultimately direct its management and policies.

This committee that directs the vote of ESOP, the majority shareholder, is appointed by Corporation's board of directors. None of the board members has familial or outside business relationships with any other director. Non-disqualified persons represent two-thirds of the board's membership. Disqualified persons hold only a minority of seats and their votes alone would not be adequate to appoint individuals to the committee that directs the vote of ESOP.

Overall, non-disqualified committee members have the authority to affect the vote of Corporation's majority shareholder. Non-disqualified board members have the authority to decide the composition of this committee and affect general corporate management and policy. Given the above facts, you have demonstrated that effective control of Corporation is with individuals who are not disqualified persons. Accordingly, your permitted holdings in Corporation are no more than 35 percent of its total stock, reduced by the percentage of stock owned by your disqualified persons.

Rulings

1. Effective control of Corporation is in one or more persons who are not disqualified persons with respect to you within the meaning of § 4943(c)(2)(B).
2. Your permitted holdings in Corporation are 35 percent of its voting stock reduced by the percentage of the voting stock in Corporation owned by all disqualified persons as defined in § 4946.

This ruling will be made available for public inspection under I.R.C. § 6110 after certain deletions of identifying information are made. For details, see enclosed Notice 437, Notice of Intention to Disclose. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

This ruling is directed only to the organization that requested it. I.R.C. § 6110(k)(3) provides that it may not be used or cited by others as precedent.

This ruling is based on the facts as they were presented and on the understanding that there will be no material changes in these facts. This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described. Because it could help resolve questions concerning your federal income tax status, this ruling should be kept in your permanent records.

If you have any questions about this ruling, please contact the person whose name and

telephone number are shown in the heading of this letter.

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representatives.

Sincerely,

Ronald J. Shoemaker
Manager, Exempt Organizations
Technical Group 2

Enclosure: Notice 437